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Farewell To LIBOR

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We all know banks are in business to make money. While most of today's banks are quite sophisticated and have multiple sources of income, the most basic and surest way to make money is to "borrow" from depositors at very low interest rates, and then lend to borrowers at higher rates. The difference between the average rate paid to depositors and the average rate collected from borrowers, referred to as the "spread," represents a profit to the bank.

Money made on the spread is a sure thing, unless the market rate of interest that must be paid to attract and keep depositors increases, while the rate collected from borrowers remains flat. For this reason, banks prefer to lend on a variable rate basis, maintaining their spread no matter how market interest rates move. This, combined with an increase in the trading of sophisticated market instruments such as interest rate swaps, foreign currency options and forward rate agreements, convinced the British Bankers Association to begin work on setting a short-term interest rate standard in 1984. On January 1, 1986, the London Interbank Offering Rate ("LIBOR") was born.

On any given day, 35 LIBOR rates are set – one for each of seven different time periods (ranging from one day to one year) in five different currencies (Dollar, Euro, Yen, Sterling, Franc). On each business day since January 1, 1986, twenty specific banks from around the world submit applicable rates "at which an individual Contributor Panel bank could borrow funds, were it to do so, by asking for and then accepting inter-bank offers in reasonable market size, just before 11:00 London time."[1] Submitted rates are used by The Intercontinental Exchange to calculate the day's LIBOR rates.

LIBOR is perhaps the most widely used set of benchmarks for determining interest rates around the world, referenced by an estimated $350 trillion of outstanding business.[2] LIBOR is used by banks and other financial institutions as a reference for determining the current rate on a variable loan (e.g. interest rate will equal 30-day LIBOR plus 3%). As LIBOR increases or decreases, so does the rate charged on a loan. It is also used as a benchmark rate for mortgages, corporate loans, government bonds, credit cards and student loans. In 2012, it was estimated that 45% of prime and adjustable-rate mortgages, and more than 80% of subprime mortgages, were indexed to LIBOR. Also, American municipalities borrowed around 75% of their total through financial products linked to LIBOR.[3] LIBOR is also referenced in other financial products, such as derivatives, including interest rate swaps and currency swaps.

Despite, and perhaps because of its widespread use, the setting of LIBOR was abused, and LIBOR ultimately became a byword for corruption. Since the rates submitted by Contributor Panel banks were not tied to specific, independent transactions, but rather were estimates or judgement calls, the final rates established each day were inexact at best. At worst, they were rates manipulated by banks in order to serve their financial interests. In 2006, a swaps trader sent a jubilant message to a counterpart at Barclays Bank who had just salvaged his interest rate trading position by helping to rig the daily rate. He wrote: “Dude. I owe you big time! Come over one day after work and I’m opening a bottle of Bollinger.” At UBS, one trader told a broker that if he left a particular rate unchanged that day, “I will do one humongous deal with you…I’ll pay you $50,000, $100,000, whatever you want.” In 2015, Tom Hayes, a former UBS and Citigroup trader, was the first person convicted in the LIBOR scandal. He once estimated that 5% of his hundreds of millions of dollars in trading profits stemmed from his ability to get LIBOR nudged up or down by a fraction of a percentage point. In August, 2015 Mr. Hayes was sentenced to 14 years in prison. Billions in fines have been assessed, and years of litigation involving numerous individuals and entities continue to this day.

In July, Andrew Bailey, the head of the UK Financial Conduct Authority, signaled the end of LIBOR, calling for reliable alternatives to be introduced by 2021. Given the recent manipulation, as well as the sharply reduced inter-bank trading activity, Mr. Bailey stated that the current situation was “not only unsustainable, but also undesirable.” Mr. Bailey is working with Mark Carney, the Governor of the Bank of England, and with other investment bankers to establish a replacement benchmark. These anticipated, and presumably tightly controlled replacements, will appear in future loan agreements. Existing, longer-term loan agreements will likely need to be amended in anticipation of the day that LIBOR rates are no longer available.

LIBOR’s demise reflects an era of greed and arrogance. Sophisticated financial products were used and abused to generate increasing revenues for financial institutions, and bonuses for individuals. Our market economy is extraordinary, enabling and enhancing our broad prosperity. But checks and balances are necessary. Henry Ward Beecher, a well-known 19th century Congregationalist clergyman, once said “All men are tempted. There is no man that lives that can’t be broken down, provided it is the right temptation, put in the right spot.” For some, money was the right temptation, and a bond trading desk was the right spot.

[1] Intercontinental Exchange - https://www.theice.com/publicdocs/ICE_LIBOR_Position_Paper.pdf
[2] Congressional Research Service - https://fas.org/sgp/crs/misc/R42608.pdf
[3] Congressional Research Service. https://fas.org/sgp/crs/misc/R42608.pdf